DEPARTMENT OF TAXATION

Amendment to Chapter 18-237,
Hawaii Administrative Rules

June 1, 2006

SUMMARY

1. New sections 18-237-20-01,18-237-20-02, 18-237-20-03, 18-237-20-04, 18-237-20-05, 18-237-20-06, and 18-237-20-07 are added.

§18-237-20-01 Reimbursement exemption, in general. (a) Section 237-20, HRS, provides that the reimbursement of a cost or advance made for or on behalf of one person by the taxpayer shall not constitute gross income to the taxpayer, unless the taxpayer receiving such reimbursement also receives additional monetary consideration for making such cost or advance.

(b) This provision was enacted by Act 297, Session Laws of Hawaii 1967 (Act 297). The Legislature believed that Act 297 "would result in increased clarity of language with respect to the taxability of reimbursements. It is the intent of this bill that payments made by one person through another without monetary gain to the latter shall not create a taxable incident under the general excise tax law". S. Stand. Com. Rep. No. 877, 1967 Reg. Sess., Haw. S.J. 1230-1231 (1967); H.R. Stand. Comm. Rep. No. 497, 1967 Reg. Sess., Haw. H.J. 658-659 (1967). Act 297, however, has not resulted in "increased clarity". Since the passage of Act 297, the courts, department of taxation (department), and practitioners, have tried to distinguish between "reimbursements" that are not gross income under section 237-20, HRS, and the receipt of other payments that are included in taxable gross income.

(c) Prior to Act 297, the law regarding reimbursements (old law), read as follows:

> Even though a business has some of the aspects of agency it shall not be so regarded unless it is a true agency. Without prejudice to the generality of the foregoing, the reimbursement by one person of the amount of costs incurred by another constitutes gross income to the latter, unless the person making the reimbursement was himself, as principal liable in that amount to the third party who furnished the property, services and the like for which the costs were incurred.

The old law provided that the reimbursement exemption was applicable to amounts repaid to an agent (taxpayer) by its principal that reimburse the agent for costs that the principal was liable for. Under the current statute, and these rules an agency relationship is not required to qualify for the reimbursement exemption; although the reimbursement exemption may apply where there is an agency relationship.

(d) The Department issued the first of two administrative guidelines, Taxability of Reimbursement of Costs or Advances under Section 117-17.1 of the General Excise Tax Law, Chapter 117, RLH 1955, as amended by Act 297, L. 1967 on June 17, 1968 (Taxability of Reimbursement, 1968). There are no substantive differences between section 117-17.1 and the current statute.

Some of the principles and examples in these rules are drawn from Taxability of Reimbursement, 1968.

(e) General Excise Tax Memorandum No. 5 was issued by the Department on December 23, 1986 as interim guidance to administer the current statute. These rules expand and clarify the concepts discussed in General Excise Tax Memorandum No. 5 and the Department withdraws General Excise Tax Memorandum No. 5." [Eff JUL 15 2006] (Auth: HRS §§231-3(9), 237-8) (Imp: HRS§ 237-20)

§18-237-20-02 Summary of the rules. The reimbursement exemption applies when:

(1) Taxpayer pays a cost or advance to Third Party (section 18-237-20-05);

(2) For or on behalf of Reimbursing Party (section 18-237-20-06); and

(3) Taxpayer is repaid the cost or advance and receives no additional monetary consideration for making the cost or advance (section 18-237-20-4). [Eff JUL 15 2006] (Auth: HRS §§231-3(9), 237-8) (Imp: HRS §237-20)

§18-237-20-03 Definitions; generally. For purposes of sections 18-237-20-01 to 18-237-20-07:

"Reimbursement" means an amount that Taxpayer receives from the Reimbursing Party for making the cost or advance for or on behalf of Reimbursing Party and does not include additional monetary consideration.

"Reimbursing Party" means the party who repays the Taxpayer for making the cost or advance to the Third Party for or on behalf of the Reimbursing Party. The term "Reimbursing Party" is used regardless of whether the amount received by the Taxpayer is a taxable or nontaxable reimbursement.

"Taxpayer" means the party attempting to claim the exemption under section 237-20, HRS, for the amount received from the Reimbursing Party. The term "Taxpayer" is used regardless of whether the amount received by the Taxpayer is a taxable or nontaxable reimbursement.

"Third Party" means the party to whom the Taxpayer pays the cost or advance and does not include the Taxpayer's employees. The term "Third Party" is used regardless of whether the amount received by the Taxpayer is a taxable or nontaxable reimbursement. [Eff JUL 15 2006] (Auth: HRS §§231-3(9), 237-8) (Imp: HRS §237-20)

§18-237-20-04 "Additional monetary consideration", defined.

(a) "Additional monetary consideration" means any amount, which Taxpayer receives that is in excess of the cost or advance to Third Party. For there to be no additional monetary consideration, the amount received by Taxpayer must be no more than the cost or advance.

Example 1: Taxpayer, a consultant, is hired by Reimbursing Party to purchase theater tickets. Taxpayer purchases tickets from Third Party. Taxpayer receives from Reimbursing Party a fee and the amount covering the price of the tickets. Conclusion: Taxpayer received additional monetary consideration because Taxpayer received the fee, an amount in excess of the amount paid to Third Party.

Example 2: Taxpayer is in the business of selling equipment. Taxpayer and an equipment manufacturer (Reimbursing Party) have entered into a preexisting cost-splitting agreement to equally share the expenses of advertising manufacturer's equipment and Taxpayer's dealership. The advertising is expected to equally benefit manufacturer and Taxpayer. The agreement provides that: Taxpayer will initially pay an advertising agency (Third Party) to provide advertising services, Taxpayer will provide manufacturer with an invoice reflecting all advertising costs, and manufacturer will repay Taxpayer for fifty per cent of the advertising costs without including any amount for Taxpayer's overhead, salaries, incidental expenses, or profit. Manufacturer repays Taxpayer. Conclusion: Taxpayer does not receive additional monetary consideration.

Example 3: Taxpayer, a real estate broker, and real estate sales agents (Reimbursing Parties), classified as independent contractors for tax purposes, have entered into preexisting cost-splitting agreements relating to the use of Taxpayer's phones by the agents to make long-distance telephone calls at Taxpayer's offices. Taxpayer makes its own long-distance telephone calls. Taxpayer pays the phone company (Third Party) for Taxpayer's and the agents' long-distance charges and collects from each agent the exact amount of long-distance charges attributable to that agent at the end of each month without including any amount for Taxpayer's overhead, salaries, incidental expenses, or profit. Conclusion: Taxpayer does not receive additional monetary consideration.

(b) "Additional monetary consideration" includes money, property, services, or any-in-kind payment or value, which Taxpayer receives that is, related to the cost or advance.

Example 4: Assume the same facts as above in Example 3, except that at the end of the month the Taxpayer receives a "rebate" from the phone company based on the volume of long-distance calls. The Taxpayer does not give any portion of the "rebate" to agents that paid for their long-distance calls. Conclusion: The Taxpayer receives additional monetary consideration unless that rebate is passed-on to each agent in proportion to the calls made by each agent and Taxpayer.

(c) "Additional monetary consideration" does not include amounts received by the Taxpayer that are unrelated to the cost or advance to Third Party.

Example 5: Taxpayer, a supermarket, advances $1,000 for Fish Market (Reimbursing Party) to a Third Party to purchase a truck. The Taxpayer receives from Fish Market $1,000 for the advance on the truck and $100 for a refund resulting from returned fish products. Conclusion: The Taxpayer did not receive additional monetary consideration because Taxpayer's $100 refund is unrelated to the cost or advance to Third Party.

Example 6: The Taxpayer manages owner's (Reimbursing Party) rental unit under a management agreement and receives a fee. The agreement requires the owner's approval for major expenditures relating to the rental unit. The carpet in the unit must be replaced. Taxpayer locates a contractor (Third Party) to replace the carpet. The carpet replacement is a major expenditure under the terms of the management agreement, and Taxpayer secures the owner's approval for the carpet replacement. Taxpayer initially pays contractor for the carpet and owner repays Taxpayer without including any amount for Taxpayer's overhead, salaries, incidental expenses, or profit. Conclusion: The Taxpayer did not receive additional monetary consideration because Taxpayer's management fee is unrelated to the cost or advance to contractor. [Eff JUL 15 2006] (Auth: HRS §§231-3(9), 237-8) (Imp: HRS §237-20)

§18-237-20-05 "Cost or advance", defined. (a) "Cost or advance" means the actual invoice amount that a Taxpayer pays to a Third Party.

Example 7: Taxpayer is in the business of selling machinery and performing warranty work on machinery. The manufacturer (Reimbursing Party) directs the Taxpayer to perform warranty work on customer's machinery. Taxpayer is unable to do such work and has another company (Third Party) perform the warranty work. The Third Party sends an invoice for $100 to Taxpayer and Taxpayer pays the invoice amount. Reimbursing Party pays Taxpayer $100 with no additional monetary consideration. Conclusion: The $100 is a cost or advance.

(b) "Cost or advance" does not include an amount that a Taxpayer pays for costs or expenses consumed by the Taxpayer, such as an amount that the Taxpayer pays to its own employees; or an amount representing usage of the Taxpayer's supplies or equipment.

Example 8: Taxpayer provides warranty work for manufacturer (Reimbursing Party). Taxpayer's employees perform warranty work, including repair services and replacement of parts for the manufacturer; no repair services or replacement of parts are performed by persons other than the employees. Taxpayer's employees receive salaries for performing repair services and replacing parts. Taxpayer bills manufacturer a fee of $1,250 plus $1,000 representing the salaries paid to Taxpayer's employees for services and replaced parts. Conclusion: The $1,000 is not a cost or advance.

Example 9: Taxpayer, an accounting firm, bills its client (Reimbursing Party) $1,000 for professional services plus $100 representing a share of Taxpayer's overhead costs, including supplies, equipment, and computers. Conclusion: The $100 is not a cost or advance.

Example 10: Taxpayer, a law firm, bills its client (Reimbursing Party) $1,000 for professional services plus $100 for copying costs at 10 cents a page. The copies were made on Taxpayer's copying equipment using Taxpayer's employees. Conclusion: The $100 is not a cost or advance. [Eff JUL 15 2006] (Auth: HRS §§231-3(9), 237-8) (Imp: HRS §237-20)

"§18-237-20-06 "For or on behalf of Reimbursing Party", defined. (a) A payment of a cost or advance is "for or on behalf of Reimbursing Party" when done at the request or direction of Reimbursing Party.

(b) A cost or advance is done at the request or direction of Reimbursing Party if:

(1) (A) The payment is made pursuant to a preexisting contract between Reimbursing Party and Third Party that creates a direct obligation for Reimbursing Party to pay Third Party for property or services;

(B) The payment is made pursuant to a preexisting contract between Reimbursing Party and Taxpayer whereby Taxpayer pays Third Party for property or services to satisfy an obligation of Reimbursing Party; or

(C) The payment is made pursuant to a preexisting cost-splitting contract whereby Taxpayer pays Third Party for property or services provided to both Taxpayer and Reimbursing Party, and Taxpayer receives from Reimbursing Party a payment proportionate to Reimbursing Party's share of the cost of the property or services based upon an actually calculable factor that has an economic basis (e.g., quantity of property, square footage, time spent, lines of advertising);

(2) A Taxpayer does not use, consume, or alter the property or services provided by Third Party. Third Party's property or services are used, consumed, or altered by Taxpayer if the property or services are incorporated into or combined with the Taxpayer's property or services or are amounts paid for the Taxpayer's overhead.

(c) "The payment is made pursuant to a preexisting contract between Reimbursing Party and Third Party that creates a direct obligation for Reimbursing Party to pay Third Party for property or services" is illustrated as follows:

Example 11: Taxpayer manages owner's (Reimbursing Party) rental unit under a management agreement that requires owner's approval for major expenditures relating to the rental unit. Taxpayer locates a contractor (Third Party) to replace the carpet. The written contract with contractor is entered into in the name of owner, rather than Taxpayer, and the contract provides that owner, not Taxpayer, is to pay for the services provided by contractor. Conclusion: The contract between owner and contractor is a preexisting

contract that creates a direct obligation for owner to pay contractor for the carpet.

Example 12: Taxpayer manages owner's (Reimbursing Party) rental unit under a management agreement that requires owner's approval for major expenditures relating to the rental unit. The management agreement provides that owner, not the Taxpayer, ultimately is to pay for all major expenditures. Taxpayer locates a contractor (Third Party) to replace the carpet. The carpet replacement is a major expenditure under the terms of the management agreement that owner ultimately is liable for, and the Taxpayer secures owner's approval for the carpet replacement. The written contract with contractor is entered into in the name of the Taxpayer. Taxpayer pays the Contractor's bill and is reimbursed by Reimbursing Party with no additional consideration. Conclusion: The payment is made pursuant to a preexisting contract between Reimbursing Party and the Taxpayer whereby Taxpayer pays Third Party for property or services to satisfy an obligation of Reimbursing Party.

Example 13: Taxpayer, the owner of an office building, leases a portion of the office building to tenant (Reimbursing Party) and agrees to provide janitorial services for tenant. Taxpayer contracts with a company providing janitorial services (Third Party) to clean the office building, including the portion leased to tenant. Taxpayer pays the janitorial services company. Tenant pays Taxpayer rent and its share of the expenses for janitorial services. Conclusion: Neither the lease nor the janitorial services contract is a preexisting contract that creates an obligation, direct or otherwise, for tenant to pay the janitorial services company for the janitorial services.

Example 14: Taxpayer leases real property from landlord (Third Party) and subleases the real property to a hamburger franchisee (Reimbursing Party). The sublease agreement specifies that franchisee's sublease rent is equal to or less than the amount of lease rent that Taxpayer is required to pay landlord (no additional monetary consideration received by Taxpayer). Franchisee pays its sublease rent to Taxpayer. Taxpayer pays its lease rent to landlord. Taxpayer's lease rent payment to landlord is not made for or on behalf of franchisee because the payment satisfies Taxpayer's obligation to pay rent to landlord under its lease and does not satisfy an obligation of franchisee to landlord. Pursuant to its sublease,

franchisee has an obligation to pay sublease rent to Taxpayer. Conclusion: The sublease is not a preexisting contract that creates a direct obligation between franchisee and landlord. This sublease also does not qualify as a pre-existing cost splitting contract under section 18-237-20-6(e) as discussed in Example 32. However, Taxpayer may be eligible for the sublease deduction under section 237-16.5, HRS.

Example 15: Assume the same facts as in Example 14, except that instead of Taxpayer directly paying its lease rent to landlord (Third Party), Taxpayer discharges its rental obligation to landlord by requiring franchisee (Reimbursing Party) to directly pay sublease rent it owes Taxpayer to landlord as a condition of the sublease. Conclusion: Franchisee's sublease rent payment is not considered a payment by Taxpayer made for or on behalf of franchisee because the sublease obligates franchisee to Taxpayer and not to landlord. Because the payment also discharges Taxpayer's underlying obligation to landlord, the payment is not a reimbursement of a cost or advance for or on behalf of franchisee to landlord. The sublease merely requires that franchisee's sublease rent payment be directed to landlord to satisfy Taxpayer's lease rent obligation. Franchisee's sublease rent payment directly to landlord is a payment for or on behalf of Taxpayer and not for or on behalf of franchisee. The sublease is not a preexisting contract that creates a direct obligation for franchisee to pay landlord the sublease rent. However, Taxpayer may be eligible for the sublease deduction under section 237-16.5, HRS.

(d) "The payment is made pursuant to a preexisting contract between Reimbursing Party and Taxpayer whereby Taxpayer pays Third Party for property or services to satisfy an obligation of Reimbursing Party" is illustrated as follows:

Example 16: Taxpayer is in the business of selling and performing warranty work on machinery. Manufacturer (Reimbursing Party) directs Taxpayer to perform warranty work on customer's machinery. Taxpayer is unable to do such work so it pays another company (Third Party) to do the warranty work. Conclusion: These warranty work expenses are paid pursuant to a preexisting contract between Taxpayer and manufacturer whereby Taxpayer pays Third Party for property or services to satisfy an obligation of manufacturer.

Example 17: Taxpayer, an attorney, enters into an agreement to represent Client (Reimbursing Party). The agreement is considered an agency agreement because Taxpayer has the power to bind Client, Taxpayer acts as a fiduciary for Client, and Taxpayer is subject to the control of Client. Taxpayer advances fees required by law (recording fees, filing fees, sheriff's fees, witness fees, fees paid to court reporters, and fees paid for publishing legal notices) to Third Parties during the course of representing Client. Conclusion: These fees are paid pursuant to a preexisting contract between Taxpayer and Client whereby Taxpayer pays Third Parties for property or services to satisfy an obligation of Client.

Example 18: Assume the same facts as in Example 17, except that Taxpayer passes-on to Client the costs paid for traveling expenses (lodging, transportation, and meals), long-distance telephone calls, and the cost of reproduction to Third Parties. Conclusion: These costs are not the obligation of client. These costs are the obligation of Taxpayer because they are necessarily incurred by Taxpayer to allow Taxpayer to perform legal services for Client. Taxpayer uses, consumes, or alters Third Parties' services to perform legal services. See section 18-237-20-6(f).

Example 19: Taxpayer, an automobile dealer, sells a car to Customer (Reimbursing Party). As part of the sales agreement, Taxpayer advances the automobile registration fee and Customer's taxes to Third Parties. Conclusion: The fees and taxes are paid pursuant to a preexisting contract between Taxpayer and Customer whereby Taxpayer pays Third Parties for property or services to satisfy obligations of Customer.

Example 20: Taxpayer, an advertising agency, agrees to produce a brochure for customer (Reimbursing Party). Taxpayer will receive a fee and the costs paid to Third Parties. Third Parties develop photographs and print the brochure and send invoices to Taxpayer. Taxpayer pays the invoices and then bills customer for Taxpayer's services and the exact amount of costs paid to Third Parties. Conclusion: While the costs of developing photographs and printing the brochure are paid pursuant to a preexisting contract between Taxpayer and customer, Taxpayer uses, consumes, or alters Third Parties' services to produce the brochure. See section 18-237-20-06(f).

(e) "The payment is made pursuant to a preexisting cost-splitting contract whereby Taxpayer pays Third Party for property or services provided to both Taxpayer and Reimbursing Party, and Taxpayer receives from Reimbursing Party a payment proportionate to Reimbursing Party's share of the cost of the property or services based upon an actually calculable factor that has an economic basis (e.g., quantity of property, square footage, time spent, lines of advertising)" is illustrated as follows:

> **Example 21:** Taxpayer sells equipment. Taxpayer and one of the equipment manufacturers (Reimbursing Party) enter into a cooperative advertising agreement to equally share the expenses of advertising Taxpayer's dealership and manufacturer's equipment. The advertising is expected to equally benefit Taxpayer and manufacturer. The preexisting cost-splitting contract provides that: Taxpayer will initially pay an advertising agency (Third Party) for all the advertising costs, Taxpayer will provide manufacturer with an invoice reflecting all advertising costs, and manufacturer will repay Taxpayer for fifty per cent of the advertising costs, without including any amount for Taxpayer's overhead, salaries, incidental expenses, or profit. Conclusion: The payment to advertising agency is made pursuant to a preexisting cost-splitting contract whereby Taxpayer pays agency for property or services provided to both Taxpayer and manufacturer. Taxpayer receives from manufacturer a payment proportionate to manufacturer's share of the cost of the property or services based upon an actually calculable factor that has an economic basis because Taxpayer and manufacturer will benefit equally from the advertising.

> **Example 22:** Taxpayer, a real estate broker, and its real estate sales agents (Reimbursing Parties), classified as independent contractors for tax purposes, enter contracts regarding sharing of sales commissions and preexisting cost splitting contracts relating to the cost of advertising real property listings in Third Party's newspaper. Taxpayer and each agent agree to place orders to advertise all of the agents' listings in a single advertisement in the newspaper. Taxpayer pays for the portions of the advertisement that refer generally to Taxpayer. All of the advertising work, except for the copy that is submitted by each agent to Taxpayer and then to Third Party, is performed by Third Party. The contract provides that Taxpayer will initially pay Third Party for all the advertising costs. Each agent will repay Taxpayer a portion of the advertising costs based

upon the total number of lines of advertising that are attributable to each agent's listings without including any amount for Taxpayer's overhead, salaries, incidental expenses, or profit. Conclusion: The payment to Third Party is made pursuant to a preexisting cost-splitting contract whereby Taxpayer pays Third Party for property or services provided to both Taxpayer and each agent, and Taxpayer receives from each agent a payment proportionate to the agent's share of the cost of the property or services based upon an actually calculable factor that has an economic basis.

Example 23: Assume the same facts as in Example 22, except that Taxpayer and the agents enter into preexisting cost-splitting contracts to equally share the cost of business cards. Taxpayer hires a printing company (Third Party) to print business cards for the agents. The cards have the name of agents as well as the name and logo of Taxpayer. Taxpayer pays the printing company for all the costs to print the agents' cards and each agent repays Taxpayer fifty per cent of the amount paid to the printing company for the agent's cards without including any amount for Taxpayer's overhead, salaries, incidental expenses, or profit. Conclusion: The payment to the printing company is made pursuant to a preexisting cost-splitting contract whereby Taxpayer pays the printing company for property or services provided to both Taxpayer and each agent, and Taxpayer receives from each agent a payment proportionate to the agent's share of the cost of the property or services based upon an actually calculable factor that has an economic basis.

Example 24: Assume the same facts as in Example 22, except that the real estate broker is the Reimbursing Party and real estate agents are Taxpayers. The real estate broker enters into preexisting cost-splitting contracts with real estate agents to equally share the cost of brochures that advertise the agents' services and affiliation with the real estate broker. The contract provides that agents will initially pay the printing company for all the brochure costs following broker's approval of the form and content of a sample brochure. Broker will repay agents for fifty per cent of the brochure costs, without including any amount for agents' overhead, salaries, incidental expenses, or profit. Conclusion: The payments to the printing company are made pursuant to preexisting cost-splitting contracts whereby agents pay the printing company for property or services

provided to agents and broker, and agents receive from broker a payment proportionate to broker's share of the cost of the property or services based upon an actually calculable factor that has an economic basis.

Example 25: Assume the same facts as in Example 22, except that Taxpayer (real estate broker) enters into preexisting cost-splitting contracts with real estate sales agents (Reimbursing Parties) to share the cost of errors and omissions insurance arranged by Taxpayer. The insurance premium paid to the insurance company (Third Party) is increased as each agent receives insurance coverage, and the agent repays Taxpayer one-half of the insurance premium attributable to the agent without including any amount for Taxpayer's overhead, salaries, incidental expenses, or profit. Conclusion: The payment to the insurance company is made pursuant to a preexisting cost-splitting contract whereby Taxpayer pays the insurance company for property or services provided to both Taxpayer and the agent, and Taxpayer receives from each agent a payment proportionate to the agent's share of the cost of the property or services based upon an actually calculable factor that has an economic basis.

Example 26: Assume the same facts as in Example 22, except that broker (Taxpayer) and agents (Reimbursing Parties) participate in the Multiple Listing Service's (MLS) (Third Party) central property advertisement and other services. Taxpayer and agents enter into preexisting cost-splitting contracts that provide that the fee for "loading" each real estate listing is initially paid by Taxpayer. The agent who has the listing repays Taxpayer one-half of the fee for "loading" the listing without including any amount for Taxpayer's overhead, salaries, incidental expenses, or profit. Conclusion: The payment to the MLS is made pursuant to a preexisting cost-splitting contract whereby Taxpayer pays the MLS for property or services provided to both Taxpayer and the agent, and Taxpayer receives from each agent a payment proportionate to agent's share of the cost of the property or services based upon an actually calculable factor that has an economic basis.

Example 27: Assume the same facts as in Example 22, except that broker (Taxpayer) and agents (Reimbursing Parties) participate in the Multiple Listing Service's (MLS) (Third Party) central property advertisement and other services. The annual dues, MLS participation fee, and cost

for MLS books are assessed to Taxpayer and each of the agents, but the invoices are sent to Taxpayer. Taxpayer and the agents enter into preexisting cost-splitting contracts that provide that Taxpayer will initially pay the MLS dues, fee, and cost for books for Taxpayer and the agent. The agent will repay Taxpayer the exact amount Taxpayer pays to the MLS that is attributable to each agent without including any amount for Taxpayer's overhead, salaries, incidental expenses, or profit. Conclusion: The payment to the MLS is made pursuant to a preexisting cost-splitting contract whereby Taxpayer pays the MLS for property or services provided to both Taxpayer and the agent, and Taxpayer receives from each agent a payment proportionate to the agent's share of the cost of the property or services based upon an actually calculable factor that has an economic basis.

Example 28: Assume the same facts as in Example 22, except that Taxpayer and the agents (Reimbursing Parties) enter into preexisting cost-splitting contracts relating to the use of Taxpayer's telephones by the agents to make long-distance telephone calls at Taxpayer's office. Taxpayer makes some long-distance calls. Taxpayer pays the phone company (Third Party) for Taxpayer's and the agents' long-distance charges and collects from each agent the exact amount attributable to each agent at the end of each month without including any amount for Taxpayer's overhead, salaries, incidental expenses, or profit. Conclusion: The payment to the phone company is made pursuant to a preexisting cost-splitting contract whereby Taxpayer pays the phone company for property or services provided to both Taxpayer and the agent, and Taxpayer receives from the agent a payment proportionate to the agent's share of the cost of the property or services based upon an actually calculable factor that has an economic basis.

Example 29: Taxpayer, an architect, enters into a contract with client (Reimbursing Party). The contract provides that Taxpayer will receive, in addition to a fee for professional services, the costs paid to Third Parties. These costs include traveling expenses (lodging, transportation, and meals), long-distance telephone calls, the cost of reproduction, and postage and handling of drawings and specifications incurred in connection with projects for client. Taxpayer pays Third Parties and breaks down the billing to client into professional services and the exact amount of these incidental costs paid to Third

Parties. Conclusion: The payments to Third Parties are not made pursuant to a preexisting cost-splitting contract whereby Taxpayer pays Third Parties for property or services provided to both Taxpayer and Reimbursing Party, and Taxpayer receives from client a payment proportionate to client's share of the cost of the property or services based upon an actually calculable factor that has an economic basis. These services are provided to Taxpayer to allow Taxpayer to fulfill its contract with client; the services are not provided to both Taxpayer and client.

Example 30: Taxpayer, the owner of an office building, leases the office building to tenants (Reimbursing Parties) and agrees to provide janitorial services for the tenants. Taxpayer contracts with a company providing janitorial services (Third Party) to clean the office building. Taxpayer pays the janitorial services company. Tenants pay Taxpayer rent and a share of the amount paid by Taxpayer to the janitorial services company. Conclusion: The payment to the janitorial services company is not made pursuant to a preexisting cost-splitting contract whereby Taxpayer pays the janitorial services company for property or services provided to both Taxpayer and tenants, and Taxpayer receives from tenants a payment proportionate to tenants' share of the cost of the property or services based upon an actually calculable factor that has an economic basis. These janitorial services are provided to Taxpayer to allow Taxpayer to fulfill its contract with tenants. The amounts received by Taxpayer for these janitorial services are deemed to be part of the rent received by Taxpayer and do not qualify as a nontaxable reimbursement.

Example 31: Assume the same facts as in Example 30, except that the owner of the office building (Taxpayer) contracts with a property management company to rent and maintain the building and the property management company contracts with a janitorial services company (Third Party) to clean the office building. Conclusion: The reimbursement exemption is not applicable to either Taxpayer or the property management company. (1) Taxpayer is subject to the general excise tax on the rent received from tenants, including the amounts received for janitorial services. The reimbursement exemption is not applicable because the payment to the janitorial service company is not made pursuant to a preexisting cost-splitting contract. (2) The property management company is subject to the general excise tax on the income received for managing the building, but

not for Taxpayer's income, including the amounts received by Taxpayer for janitorial services.

Example 32: Assume the same facts as in Example 14. Conclusion: Franchisee's (Reimbursing Party) sublease rent payment is made pursuant to a sublease between Taxpayer and franchisee, not pursuant to a preexisting cost-splitting contract. Unlike a preexisting cost-splitting contract involving three parties where Taxpayer and Reimbursing Party agree to proportionately share the cost of property or services provided by Third Party to both Taxpayer and Reimbursing Party, a sublease is a contract between only two parties where one party (the franchisee/Reimbursing Party) agrees to pay rent to another (Taxpayer) in return for the use and possession of property. In this lease-sublease arrangement, the landlord (Third Party) provides the use and possession of property to Taxpayer in exchange for rent. Subsequently, Taxpayer provides the use and possession of the property to franchisee/Reimbursing Party in exchange for rent. The property is not provided to Taxpayer and franchisee at the same time, and the cost of using real property is not shared by Taxpayer and franchisee.

(f) "Taxpayer does not use, consume, or alter the property or services provided by Third Party" is illustrated as follows:

Example 33: Taxpayer is in the business of selling and performing warranty work on machinery. Manufacturer (Reimbursing Party) directs Taxpayer to perform warranty work on customer's machinery. Taxpayer is unable to do such work so it pays Third Party to do the warranty work. Conclusion: Taxpayer does not use, consume, or alter Third Party's services because the warranty work is not incorporated into or combined with Taxpayer's property or services. Third Party's warranty work is provided to manufacturer's customer.

Example 34: Assume the same facts as in Example 29, relating to the architect. Conclusion: The traveling expenses, long-distance telephone calls, the reproduced items, and postage are used, consumed, or altered because these incidental services are incorporated into or combined with Taxpayer's architectural services.

Example 35: Taxpayer, an interior decorator, is hired to decorate customer's (Reimbursing Party) house. Taxpayer buys rugs and furnishings from a furniture store (Third

Party) for customer. Conclusion: Taxpayer uses, consumes, or alters Third Parties' property because the property is incorporated into or combined with Taxpayer's interior decoration services.

Example 36: Taxpayer, an accounting firm, is hired by customer (Reimbursing Party) to audit its financial records. Because the audit requires more personnel hours than could be performed by Taxpayer's personnel, Taxpayer contracts with another accounting firm (Third Party) to perform part of the audit work, and combines that work with the work of Taxpayer's auditors. Taxpayer pays the other accounting firm. Conclusion: Even if Taxpayer separately bills customer for the exact amount paid to the other accounting firm, Taxpayer uses, consumes, or alters the other accounting firm's services because the services are incorporated into or combined with Taxpayer's services.

(g) A cost or advance cannot be made for or on behalf of Reimbursing Party if Taxpayer makes the cost or advance before a request by Reimbursing Party.

Example 37: Assume the same facts as in Example 16, relating to warranty work on customer's machinery. Conclusion: The payment for warranty work is a cost or advance because Taxpayer makes the cost or advance (payment of expenses) after a request by Reimbursing Party.

Example 38: Taxpayer signs a contract with Third Party that provides Taxpayer unlimited access to a research database. Taxpayer subsequently allows Reimbursing Party to access the database using Taxpayer's account and charges Reimbursing Party one-half of the access fee. Conclusion: The access fee is not a cost or advance for or on behalf of Reimbursing Party because Taxpayer makes the cost or advance (purchase of access to the data base) prior to any request by Reimbursing Party. [Eff. JUL 15 2006] (Auth: HRS §§231-3(9), 237-8) (Imp: HRS §237-20)

§18-237-20-07 Burden of proof on Taxpayer. (a) Taxpayer has the burden of providing evidence satisfactory to the Department that Taxpayer qualifies for the reimbursement exemption. Whether the transaction qualifies for the reimbursement exemption is determined by all the facts and circumstances; no single factor is controlling.

(b) The designation or characterization by Taxpayer of a receipt of a payment as a reimbursement that qualifies for exemption from the general excise tax is not controlling. The substance of a transaction, not the form of the transaction nor the designation used by Taxpayer, shall determine whether the reimbursement exemption is applicable.

Example 39: Taxpayer provides market surveys, issues press releases, and places advertisements for client (Reimbursing Party). Taxpayer's contract with client includes a provision that costs of transportation, living expenses when traveling, payments for long distance telephone calls and telegrams, and other payments to Third Parties are deemed "reimbursements". Taxpayer's billings to client are broken down into services and "reimbursements". Taxpayer receives payments from client and files a general excise tax return and excludes these costs paid to Third Parties claiming the reimbursement exemption. Conclusion: The expenses designated by Taxpayer as "reimbursements" do not qualify for the reimbursement exemption because the payments from Taxpayer to Third Parties were not for or on behalf of client. The property or services provided by the Third Parties were used, consumed, or altered by Taxpayer. Even though Taxpayer has claimed these costs as qualifying for the reimbursement exemption, such costs do not qualify for the reimbursement exemption." [Eff JUL 15 2006] (Auth: HRS §§231-3(9), 237-8) (Imp: HRS §237-20)

DEPARTMENT OF TAXATION

Amendments to Chapter 18-237, Hawaii Administrative Rules, on the Summary Page dated June 1, 2006, were adopted on June 1, 2006, following public hearing held on May 24′ 2006 and reconvened on June 1, 2006 for decision-making, after public notice was published in the Honolulu Star-Bulletin, the Garden Isle, the Maui News, West Hawaii Today, and the Hawaii Tribune-Herald on April 21, 2006.

These amendments shall take effect ten days after filing with the Office of the Lieutenant Governor.

KURT KAWAFUCHI
Director of Taxation

APPROVED:

JUL -5 2006

LINDA LINGLE
Governor
State of Hawaii

Dated:_____

APPROVED AS TO FORM:

Deputy Attorney General

LIEUTENANT GOVERNOR
STATE OF HAWAII
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